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General Business Conditions

THE opening weeks of the fall season have not produced any striking changes in the business climate. Activity picked up in retail trade and also in a number of manufacturing lines, though sales and new order inflows were quite commonly disappointing. On the whole, economic data available for September indicate an extension of the high-level plateau, which began forming as early as last December in industrial production and more recently for other measures. The climb has leveled out in business investment, personal income, and gross national product. Reflecting particularly the opening up of new jobs in service industries, employment (including the Armed Forces) this past summer averaged 71 million persons, higher than ever before.

If prosperity were only a matter of the size of the gross national product, or of the over-all level of income, employment, and industrial output, it would be hard to find fault with current business conditions. The strong showing of most

comprehensive economic measures so far this year leaves little doubt that 1960 as a whole will set new records exceeding any previous year. Gross national product in the third quarter probably held at about the record second quarter rate, equivalent to \$505 billion a year, as rising final demand for goods and services offset declining inventory demand. In August, personal income edged up to a new high annual rate of \$407.6 billion. The industrial production index (1957 = 100) held at the lower end of the 109-111 range it has maintained since last December. With Western Europe still booming and restrained in competing for exports by powerful domestic demands, U.S. export business in 1960 has been a point of exceptional strength.

Nevertheless, a conspicuous degree of caution prevails, particularly in the business community. This reflects disappointment that sales volumes this year have not reached even higher levels, shrinkage in order backlogs from the peak reached during the steel strike, competitive pressures on prices, and a developing squeeze on profit margins. Appreciation of these facts helps explain the September selloff in common stocks which brought prices to new lows since late 1958.

Capital Investment Topping Off

Conservatism in business policy has been most apparent in inventory buying, but more recently it has shown up in some trimming back of capital investment plans. Evidence of this was contained in the quarterly survey by the Securities and Exchange Commission and the Department of Commerce issued in September. Nonfarm business outlays for new plant and equipment in 1960, which at one time were expected to set a new record, now appear more likely to fall short of the 1957 peak of \$37 billion by about \$600 million or 2 per cent. However, total outlays are still scheduled to rise 12 per cent from 1959; the highest increases are among durable goods manufacturers, who are boosting their plant and

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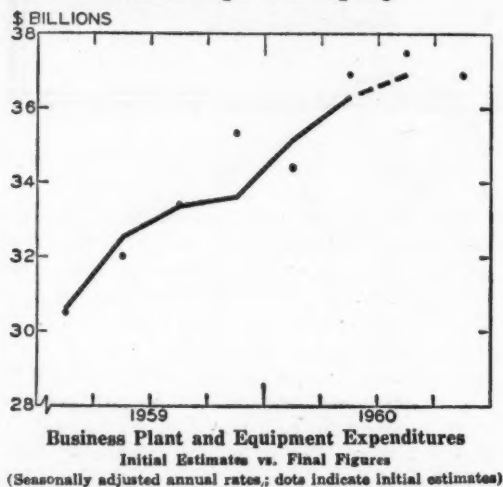
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equipment purchases by 26 per cent. All major industrial groups now expect capital outlays in the second half to equal or exceed those in the first half of 1960, but most groups have cut back their second half capital expenditure programs from the levels anticipated last spring.



The SEC asks businessmen to report their anticipated capital spending a month or two before the start of each quarter and then six months later asks them what they actually spent in that quarter. When business is booming, firms often spend more than they had planned, but toward the end of an upswing actual investments tend to fall short of anticipated levels, as outlays are deferred or canceled. As the accompanying chart shows, expenditures were less than expected in the second quarter of 1960 and, from preliminary data, that was also the case in the third quarter. Initial spending plans for the fourth quarter are somewhat lower than the more optimistic initial plans for the second and third quarters. Unmistakably, plant and equipment outlays are topping off. This is not inevitably the prelude to a major contraction. Congress has power, through tax reforms, to give support to capital spending by business.

For a number of products, markets have become more strongly competitive this year because of ample capacity and lagging orders. Some shaving of prices has resulted and profit margins have been squeezed. While lower profits cut into a firm's ability and incentive to finance plant and equipment investment, they also heighten cost-consciousness. Businessmen are on the alert, now more than ever, for new equipment or better plant layouts which will improve productive efficiency and reduce their costs, and for new products to broaden their markets. The development of new products and the desire for

modernization — together with the necessity for replacement — help keep a floor under capital investment so far as money can be found.

The Swing to Inventory Liquidation

Since early this year, businessmen have been taking a conservative view of inventories. Ordering has been cautious, and in recent months factory stocks of purchased materials have declined. However, inventories of finished goods in both manufacturing and trade have continued to mount. It must be assumed that a large part of the recent buildup has been involuntary; the National Association of Purchasing Agents reported that in August only 13 per cent of the members surveyed were still accumulating inventories, while 41 per cent were reducing stocks.

Inventory demand reached a peak in January, when the book value of business inventories was rising at a rate of more than \$13 billion a year. The rate of accumulation dwindled sharply during the first half. In July, the balance between accumulation of finished goods and cutbacks in purchased materials swung over to liquidation at an annual rate of about \$1 billion. Thus, in six months the demand for goods shrank by roughly \$14 billion because of the shift in inventory policy. That by itself was enough to take the edge off many an ambitious sales forecast.

Nowhere has the inventory shift been more pronounced than in the steel industry. The National Industrial Conference Board estimates that in the third quarter steel fabricators consumed about three million more tons of steel than they received — roughly the same amount as was added to stocks during the first half — thus pulling their steel inventories back to the low level at the end of 1959. Most steel buying continues on a hand-to-mouth basis and any marked rise in metalworking activity would quickly be reflected in demand for steel.

For steel, the inventory adjustment is largely complete. For some other industries adjustments are in process to bring stocks into line with sales performance.

The Hesitant Consumer

During the third quarter, the annual rate of personal income probably averaged about \$3 billion higher than in the second quarter, but this flow of purchasing power is not fully reflected in retail trade statistics. People no doubt are spending more on vacations, tuition, and other services, as well as meeting higher tax bills, but retail sales in August and September failed to rise as much as expected.

Various surveys of consumer attitudes and buying plans have noted a hesitancy among con-

sumers, also apparent in their reluctance to add further to installment debts. The key to a change may well be the reception which consumers give to the 1961 model passenger cars, most of which will be introduced by mid-October. Last year, Detroit could not fully capitalize on the buying interest aroused by new compact models because the steel strike curtailed output of new cars. This year, four new compacts will be offered, bringing the domestic total to ten. Manufacturers have stepped up production to assure dealers of adequate supplies, and by September 20 were estimated to have turned out about a quarter million '61 models.

At the same time, a dark shadow overhangs the auto market in the form of about 575,000 unsold 1960 models as of September 20. If these stocks are not greatly reduced before introduction dates for the '61s, there is the danger that cut-price sales of old models may take the edge off the market for new ones.

Intensive sales efforts in mid-September brought some improvement in new car sales, which had been lagging behind 1959 levels during most of the summer. In the first nine months of 1960, over 4½ million new domestic cars were sold, about 8 per cent ahead of the same 1959 period. In contrast, sales of imported cars, for which data are available only through the first seven months, have lagged 10 per cent behind the corresponding 1959 months. On balance, with a reasonably good fourth quarter, sales of 6½ million domestic and imported cars in 1960 as a whole are well within reach, making it a year second only to 1955.

Reshaping the Federal Debt

There is an old saw that goes: "If you look after the short run, the long run will take care of itself." In the field of federal debt management, this is unfortunately not true; the long-term debt of one generation becomes the short-term debt of the next. The simple ticking of the clock makes any given Treasury bond issue a shorter-term obligation, and slowly but inexorably changes its basic nature as an investment instrument. In 15 years a 25-year bond becomes a 10-year bond with greatly reduced risks of market price fluctuations; in nine years more the possible range of market price fluctuation is very limited and the bond becomes a one-year money market instrument — an interest-bearing equivalent for money.

This change in the basic nature of the investment instrument induces a gradual shift of ownership. A 25-year bond has its main market among long-term investors such as life insurance

companies and pension funds which buy for the interest return over the years, have no plan to sell, and are able largely to ignore changes in market prices. As the bonds drop down to a point where they are no more than 10 years to maturity, and the risks of market price fluctuation are much reduced, commercial bank buying interest appears and strengthens further as the maturity gravitates down to five, four, three, and two years. When the bonds drop down to within one year of maturity, active buying interest crops up from corporations, foreign accounts, and others who want to hold dollars in an interest-bearing form with very limited market risk.

We can see what has happened to the \$101 billion of marketable Treasury bonds floated in 1941-45 to finance the Second World War. With the passing of the years, increasing amounts of these bonds have fallen due so that, quite apart from its massive floating debt in Treasury bills and certificates, the Treasury has had to do more and more borrowing to pay off maturities. A few sales of long-term bonds have been undertaken since 1953, but the bulk of refinancing of maturities has been handled by sales of short- and intermediate-term securities with effects of creating a marketable debt of \$80 billion due within one year and \$62 billion due in one to five years as of the beginning of 1960.

With the passing of time, the debt due within one year constantly tends to increase, enlarging Treasury refunding problems, embarrassing Federal Reserve efforts to keep the economy on an even keel, and dangerously swelling the supply of money and money equivalents in the economy.

Operations Leapfrog

In June the Treasury acted to nip this process in the bud. It tested out for the first time the much discussed technique of "advance refunding," on a bond 17 months from maturity, approaching the status of a money market instrument.

By a "junior leapfrog" operation, holders of the largest single Treasury bond outstanding, the \$11.2 billion of 2½ per cent bonds due November 1961, were given the option to exchange for 3½ per cent notes of May 1964 or 3½ per cent bonds due May 1968. Subscriptions to the four-year notes reached \$4.6 billion, requiring 85 per cent allotments to limit the new issue to \$3.9 billion; another \$322 million was exchanged for the eight-year bonds.

Of the marketable bonds sold in financing World War II, and largely held by long-term investors, the most important group left outstanding has been \$28 billion in nine issues of 2½s,

mainly those sold "on tap" in the successive War Loan drives. The passage of time has brought the maturity of these bonds, originally 25-30 years, down to a point where the dates for final repayment now lie only seven to 12 years ahead. In other words, the old War Loan 2½s were and are at a point where they tend to shift away from long-term investors.

To retard this tendency, the Treasury last month undertook an operation "senior leapfrog." Over the period September 12-20, holders of four issues of the wartime 2½ per cent bonds falling due between 1967 and 1969 were given an opportunity to exchange these securities for three issues of 3½ per cent bonds with maturities in 20, 30, and 38 years. The exchange options offered by the Treasury, the amounts held by the public (outside U.S. Government investment accounts and Federal Reserve Banks), and the amounts exchanged into 3½ per cent bonds, are shown in the following table:

Eligible 2½% Bonds		Exchanged into 3½% Bonds	
Maturity	Millions	Maturity	Millions
June '62-67	\$ 1,839	Nov. '80	\$ 711
Dec. '63-68	2,391	Feb. '90*	775
June '64-69	2,283	Nov. '98	2,103
Dec. '64-69	2,283		
Total	\$10,801		\$3,889†

* Reopening of bond originally issued February 1958.

† An additional \$584 million was exchanged by Government investment accounts.

The Treasury put a limit of \$5 billion on exchanges into the two longest-term issues but, as the table indicates, this limit was not effective because the exchanges did not reach that magnitude. The percentage of exchanges was naturally smallest on the June 1962-67 maturity of which a considerable portion already had shifted into the hands of banks which were disinclined to exchange a seven for a 20-year maturity even for the benefit of a one per cent increase in interest rate return. The most solid achievement was the placement of more than \$2 billion 38-year bonds with long-term investors, in exchange for the 2½s of 1964-69.

The ground has been laid for a similar type of exchange offering next year for five wartime 2½ per cent bonds maturing between March 1970 and December 1972. Meanwhile, another "junior leapfrog" would be appropriate to deal with the swollen maturities in the one- to five-year maturity zone.

It is incredible but true that more than three-quarters of the marketable federal debt now falls due within five years. It will take continuous effort just to keep this proportion from growing even higher. It will also take continuous effort for the Treasury to build and keep a place for itself in the long-term bond market, through long-term cash offerings from time to time.

A Gift to Bondholders?

Some other nations have undertaken much more ambitious programs for refinancing indebtedness incurred during World War II. The most spectacular operation was that of the Canadian Government two years ago, when no less than one third of the total Canadian debt was exchanged into longer-term securities offering holders rates of 3¼, 4¼ and 4½ per cent in exchange for five issues of 3s.

Operation "senior leapfrog" involved only one per cent of the \$289 billion Federal debt and the increase in coupon rate offered, as an inducement to taking much longer-term obligations in exchange, amounted to only one percentage point. Nevertheless, the Treasury came under sharp attack for "giving something away" to bondholders and saddling taxpayers with extra interest expense.

How little truth there was in this accusation is evidenced in the fact, brought out in the foregoing table, that most holders passed up the opportunity. Of the \$10.8 billion publicly held bonds eligible for exchange, slightly less than one third were turned in. Holders recognized that the 3½ per cent bonds would not be worth, in the market, significantly more than the 2½ per cent bonds they already held because of the added risk of market price fluctuation which comes with a longer maturity. In the long run, it is quite possible that 3½ per cent, subject to heavy rates of income taxation, will prove to be a moderate interest cost for taxpayers to shoulder. It is less than the rate that the Treasury would need to pay today to do any financing on paper due beyond five years.

There is little doubt but that most of the exchanges were made by people who had bought the bonds to help in the war-financing effort. The talk of "gifts to bondholders" invites a calculation of how the original subscribers of the bonds have made out over the years, taking account of what the intervening 82 per cent rise in the cost of living has done to shrink values of bonds and bond interest coupons.

The issue of June 1962-67, sold on a dark day in May 1942 when Corregidor was being surrendered to the enemy, can serve as an example. A patriotic citizen investing \$10,000 figured on getting a \$250 a year return before tax. He still gets the \$250 a year but its real buying power has shrunk to a point where it now amounts to \$137 if calculated in May 1942 prices. If he accepted the offer to exchange and gets 3½ instead of 2½ per cent, his return rises to \$350. This amount, however, if calculated in May 1942 prices,

shrinks to \$192 or 23 per cent less than he bargained for when he bought the bond.

The arithmetic comes out worse if account is taken of income taxation: income taxes are higher now than they were in May 1942.

All this omits notice of the shrinkage in the value of the initial investment. The rise in the cost of living means that the \$10,000 tied up in the bonds is worth today in real terms no more than \$5,500. The loss of principal is almost exactly equal to the \$4,500 aggregate of interest received — without any allowance either for income taxation or the shrinking real value of the successive interest coupons. Everything considered, the fact emerges that the investor has had no income over the 18 years.

There is the final point that the bonds do not bring face value in the market. Either the old 2½s or the new 3½s are currently quoted at about 95 cents on the dollar. Here is a further 5 per cent loss of principal though it can be avoided by holding the bonds to maturity.

There are people who have said that it is a shame and a disgrace for U.S. bonds to sell at a discount and who would propose to have the Federal Reserve Banks exercise their powers of money creation to buy up U.S. bonds and drive their prices up to face value. This would be a kind of gift to the bondholder; the Government has no obligation to pay par prior to maturity. But the effect of such an arbitrary course of action would be to inflate the currency, drive living costs still higher, and make the real value of bonds even less.

There is no salvation for holders of evidences of U.S. Government debt, nor for the dollar as a domestic and international standard of value, ex-

Experience of \$10,000 Invested in May 1942 In 2½% War Bonds Due in June 1962-67

	Interest Income	
	Before Tax	After Tax*
Income per annum	\$ 250	\$ 200
Income in 1960 at 2½% expressed in May 1942 dollars	137	110
Income in 1960 at 3½% expressed in May 1942 dollars	192	154
Income received, 18 years to May 1960 \$4,500		\$ 3,604
Income received, 18 years to May 1960 expressed in May 1942 dollars	2,473	1,980
Loss of income from inflation	\$2,027	\$ 1,624
		Principal Value
Face value and cost of original investment		\$10,000
Face value of investment expressed in May 1942 dollars		5,495
Loss in face value from inflation		\$ 4,505
Face value and cost of original investment		\$10,000
Recent market value (at 95) expressed in May 1942 dollars		5,220
Loss from inflation and market price depreciation		\$ 4,780

*At initial personal income tax rate.

cept by the pursuance of sound policies of government expenditure, taxation, and debt management. Any new Administration taking office next January will have to face up to the practical fact that the United States Treasury must studiously avoid letting short-term debt pile too high and must maintain for itself a place in the long-term investment market. The public debt is too large, the prospects for substantial debt retirement too dim, to permit any other course.

The Costs of Economic Growth

Both political parties agree on one salient issue of our domestic affairs — faster economic growth is a desirable goal of national policy. The nation is sensing the challenge of more rapid progress in Russia and elsewhere in the world. Economic growth, with its visions of an ever bigger economy and an ever better life for all, clearly is judged to have ringing political appeal for voters this November.

The platforms of both parties emphasize the necessity of a stepped-up growth rate. The Democratic Party platform declares: "We Democrats believe that our economy can and must grow at an average rate of 5 per cent annually, almost twice as fast as our average annual rate since 1953." Without setting a predetermined rate for growth, the Republican Party platform urges that we "quicken the pace of our economic growth to prove the power of American free enterprise to meet growing and urgent demands."

In itself, discussion of the growth rate reflects a more optimistic attitude than was common 20 years ago. Then we were supposed to be a grown-up mature economy, confronted with "secular stagnation." The economic problem that loomed largest in men's minds was creating enough jobs to prevent massive unemployment. Labor-saving technological improvements were blamed as a prime cause of unemployment rather than understood as means to economic progress. Consumption, it was said, could not keep pace with productive capability.

World War II demonstrated America's capacity to produce on a scale previously unknown. The decade of the '50s showed an ability to consume on a scale beyond any previous parallel.

The achievement of the '50s — which produced a 47 per cent expansion of real output — should not be minimized. Looking to the future, however, we must be alert to the needs for continued progress, to feed, clothe, and house a growing population, to maintain strength to deter aggressors and prevent the catastrophe of a nuclear war, and to keep a place of leadership among the

nations in a competitive, dynamically changing world. We wish to give our young people greater challenges and broader opportunities to make the most of their native abilities.

The question is not whether growth is desirable. The question is how to get it.

It can be fairly assumed that the new Administration taking office next January will wish to stimulate real as opposed to fictitious growth. What can be done? What sacrifices should be asked of the American people to enlarge the national productive power? Questions of *real* economic growth demand answers in the *real* terms of effective human effort on the job.

Aspirations for economic growth come into conflict with desires for leisure, appetites for immediate consumption, and wishes to redistribute the national income on the basis of need and protect people from the hardships and insecurities of a dynamically growing economy. But a nation gets in production what it pays for in toil and sweat, in human effort intelligently and efficiently applied.

Growth and Government

The general measure of economic growth is the expansion of the gross national product—the aggregate money value of goods and services produced. The GNP in 1960 is passing \$500 billion for the first time. That is the base point. How long will it take to reach \$1,000 billion? Will this trillion-dollar level, when achieved, represent constructive accomplishment? Or will it simply reflect a shrinking dollar? The doubling from \$250 to \$500 billion, 1948-1960, was three-fifths real and two-fifths inflation.

We used to count on the initiative of exceptionally talented individuals, in a land of opportunity, to guarantee progress. And it did, in an uneven but yet spectacular fashion. Now it is commonly held to be up to government to do something to accelerate the rate of growth. This assumption is no doubt correct. Government plays such a large part in our lives these days, handles so much of our money, and constricts our opportunities in so many ways, that changes in government policy become prerequisite to any dramatic changes in the growth pattern.

But we must be wary of steps which will give no more than an illusion of progress. It is all too easy to manipulate the GNP to higher levels.

One pitfall is to think in terms of nominal production rather than useful production. For example, the government can easily bring about more rapid growth by encouraging the production of farm commodities which may be unsal-

able in a free market, but which, included at their support prices, swell the GNP and give a false appearance of progress. If growth is to be more than a statistical game, it must imply the production of things people want and are willing to pay for.

Government can enlarge the calculated GNP by raising the salaries of its employees, by forcing government contractors to pay higher wages under the Walsh-Healey Act, and by generally spending and lending more freely. This is a tempting course but it amounts to no more than shrinking the dollar yardstick by which values of goods and services are measured. We have already had too much of illusory growth by inflation. We want the genuine article.

Enlarged government spending is the easy answer for providing more jobs and income. It is all too easy. The record shows that it leads to inflation and higher taxes which curtail the real buying power of take-home pay and deny possibilities for balanced growth.

This may seem all well and good to those who think the citizen is too affluent already. But it overlooks the essential fact that the worker wants more out of life than public works and needs something other than government hand-outs to stimulate effort.

The Quantity and Quality of Labor

The immediate way to enlarge production is to make more intensive use of existing resources. So far this year an average of 69 million persons are employed, more than one million above the 1959 figure and the largest number in our history. Yet, undoubtedly, there is spare capacity of labor. For every seven workers there are eleven counted as nonworkers, including children, housewives, and the aged. For every eighteen workers there is one person reportedly seeking a job. This implies some surplus of labor; under favoring conditions the employment total could be lifted by at least 2 per cent.

Unemployment basically reflects the freedom of employees to quit and change their jobs and the freedom of employers to adjust work forces to their needs. Our failure to reach even higher employment levels has a wide variety of causes—the attractions of leisure, prolongation of the educational process, earlier retirements, and lacks of skills and mobility among people. Since there are many unfilled job opportunities, employment could be increased by greater efforts to find jobs. Government could help by reviewing policies that discourage employment and shorten working careers at both ends.

A more spectacular way to raise the level of the national production would be to increase the length of the work week. But such a step would run against one of the most clearly marked trends in the American society. For a century the work week has gradually been shrinking. The people have chosen to appropriate some of the fruits of progress for increased leisure.

Leisure, even though not counted in the GNP, has undeniable values and often is employed in productive ways—odd jobs around the house, studying for personal advancement, or participating in community projects. But it is generally true that labor resources are most efficiently employed in organized groups in the pursuit of wage or salary income. If we really want to produce much more there is no escape from the principle that, individually and collectively, we must work longer, harder, or more efficiently.

One good way to enlarge production is to upgrade the competence of the individual by education. This possibility is getting its deserved full share of attention. Yet we come up against hard facts: the educational process, if it is to be effective, requires work on the part of teacher and pupil alike. As a college professor writes:

Much of the present discussion of "education" as a key to the future growth of the nation misconceives the main point involved. If Americans attempt to make education a pleasurable experience with little effort involved, then irrespective of nominal expenditures on "education" it will bring about little progress and little improvement in the nation's human resources.

An excellent physical plant, impressive-sounding programs and coursework, even higher salaries for teachers (despite the claims of the lobby of educators) will not improve education, although they may play a part. The crucial ingredient is the desire to learn and to work. . . . But such attitudes imply the sacrifice of present satisfactions and run against the grain of a pleasure-loving people who have been taught to believe that everything will become easier in the future.

Here we come up against a question of national morale. Are we in a mood to put in the effort and make the sacrifices to speed growth?

Savings and Investment

The growth of population, by enlarging the labor supply, tends to increase the gross national product. It does not, however, tend to increase output per head. Indeed, great amounts of money must be invested each year to prevent the growth of population from reducing the ratio of capital equipment to manpower and thus the national income per person.

Our factories and power plants, our railroads, airlines, and telephone systems are embodiments of past saving. They are there because people in

years past were willing to save, to forego current consumption. They represent stored-up labor. They must be renewed if we are to sustain our living standard. They must be expanded if we are to provide for population growth. They must be renewed, expanded, and improved if we are to have progress. We will need to tone down our emphasis on consumption and take a closer look at the problem of capital formation.

Most of all we will have to replenish the pools of venture capital, the money that goes into brand-new enterprises which are the seeds of progress. Many new ventures fail but some, like acorns strewn on the ground, will survive and grow into industrial giants of the future, producing products now unknown.

We have benefited so long from the savings-investment process that we tend to take it for granted. This is a serious mistake if we really want to accelerate economic growth and most particularly if we want an easier life as we go along, with shortened working hours, more paid time off the job, and earlier retirements. We will need to give every encouragement to inventive genius and get machines to do more of the work for us. Machines do not get designed, built, repaired, and operated without dedicated effort. There is a tremendous challenge, improving upon the phenomenal achievements of the past.

Costs of Technological Progress

As the distinguished French economist, Jacques Rueff, has said:

All economic progress is nothing, basically, except an incessant struggle between the call of the future and the defense of the past.

We achieve progress by changing ways of doing things and replacing new products for old. This involves costs of junking machinery, plants, and even entire industries, which progress has made obsolete. More important, it involves losses of old jobs and values of old skills acquired out of years of experience as new jobs and new skills are created. There are thus not only losses for investors but losses of jobs for people. In the past, we have accepted these costs of progress and that is an important reason why we have progressed so far. If we really want to speed economic growth, we will have to recognize and accept such costs.

The problem is symbolized by the so-called depressed areas where there are pockets of long-term unemployment. The tendency is to support these people where they are—and thus leave the problem unresolved—when the need is to encourage them to equip themselves for new and different jobs and, if necessary, to move where

employment opportunities exist. The ability of the free society to survive and expand rests on the self-reliant adaptability of the individual.

In his thoughtful new book, *The Cost of Freedom**, Professor Henry Wallich of Yale, presently on leave as a member of the President's Council of Economic Advisers, suggests that a free society may not be able to compete with a totalitarian state—that more moderate growth may be a price of freedom. He would not want us to sell our "birthright of freedom for a mess of production accelerated by forced draft methods." The provocative question arises: is growth so important that we should adopt a totalitarian regime to get it? If so, we forsake our concept of the dignity of man and give up without a battle in the contest of ideologies.

But it is unnecessary to concede that our system cannot compete. Our national history shows that it can. After all, the basis of all production and all accomplishment is the individual—the industrious, self-reliant man striving to get ahead in life and giving value to money by being willing to work for it.

Perhaps our failures to realize more growth are merely symptomatic of undue preoccupation with providing increased income security to non-workers while loading higher taxes each passing year on work and production. The most vital thing we can do is revivify incentives to work and enterprise. It all comes back to the carrot or the stick. The tangible reward is more effective than compulsion to motivate men. Even the Russians have learned this lesson and have chucked overboard ideals of socialist egalitarianism. They plan to abolish income taxation entirely.

Tax Policies for Growth

Extremes of income taxation are even less acceptable here than in Russia. We have the same need for inequality of incomes to provide rewards for superior responsibilities and performance. We also have need for accumulation of venture capital, the lifeblood of capitalism. In Russia government can and does raise venture capital by taxes on consumption.

Some theoreticians hold that achievement alone, together perhaps with associated popular acclaim, are rewards enough for exceptional people. But these things most obviously are not enough where an enterprising young man needs more money to start a business or finance expansion.

Even large, growing firms experience difficulties in raising all the capital they need to put in

place the most modern new machinery and keep up with their competitors. These difficulties stem from inflation which makes depreciation allowances inadequate, from the speeding of the process of technological change, and from a tax system which appropriates to government the main fruits of success.

Around the world we can see many examples of the contribution that tax reforms can make to economic progress. As Congressman Wilbur D. Mills, Chairman of the House Ways and Means Committee, has pointed out repeatedly, our tax system is a major drag on the growth of the U.S. economy.† If we want to keep up in the race we ought to let up on the brakes.

The troubles with our tax system are mainly two: first, confiscatory income tax rates which hurt the revenues, drive away taxable income and effectively subsidize tax-deductible outlays and tax-exempt forms of corporate organization; second, abnormal concentration of taxes (income, employment, etc.) on work and production. This situation could be rectified with the help of tightened budget policy and a low-rate general sales or excise tax. It is doubtful that the U.S. economy will show any burst of sustained new energy until the critical problem of tax reform is dealt with.

Other nations have thrown off the shackles of bad tax systems. There is no reason we should not emulate good example.

†For fuller discussion of the tax problem, see the following articles in previous issues of the *Letter* this year: "Reviewing Our Tax Position," January; "Taxation of Corporate Dividends," July; and "Depreciation Allowances Here and Abroad," September.

Foreign Aid — 1960 Style

At the Americas' Economic Conference in Bogotá last month, the United States promised to devote over the years "large additional resources to the inauguration and carrying forward of a broad new social development program for Latin America." This new program—together with the establishment earlier this year of the Inter-American Development Bank, the creation last week of the International Development Association, and President Eisenhower's call at the United Nations for a new "long-term African development program"—brings foreign aid once again into the limelight.

Flows of government economic aid to the underdeveloped parts of the world have never been bigger than at the present time. Yet, many wants for aid among less-developed nations remain unsatisfied. Their hunger for capital has been stimulated not only by growing populations and eagerness to raise living standards, but also by

*Harper & Brothers, New York, New York, 1960.

quicken political and social changes since World War II.

Providing capital for less-developed nations is "the challenge of our time," as a special committee headed by Mr. W. Randolph Burgess, U.S. Permanent Representative to the North Atlantic Council, recently stated in a report dealing with future economic cooperation among the United States, Canada, and Western Europe:

We are convinced that none of the problems facing our countries collectively is more important than that of assisting the under-developed countries in their progress towards higher living standards, greater freedom and a fuller life for their peoples.

Growth of Inter-Governmental Loans and Grants

During the 19th century and, indeed, until about a generation ago, economic development proceeded by leaps and bounds without anybody's being concerned about the "problem." As Europe increased its savings, capital became available for investment in America and wherever else Western civilization was free to enter. Individual savers in England and other European countries thus lent money to the pioneers of our prairies, the Australian bush, and the Argentine pampas; they also invested heavily in Asia and Africa. Apart from wars, government-to-government loans were almost unknown; there were no international development agencies and no "experts" prescribing a "rate" of economic growth. Investment rested on the free market, the rule of law, and respect for money. Progress, springing from the inventive genius of free men, could be taken for granted.

The United States and other nations that made extensive use of private foreign capital suffered in no way for having attracted it. The performance, of course, varied from country to country and from time to time. There were defaults, but, on the whole, capital-exporting nations earned reasonable rates of return for risks taken.

During the late 1920s and the 1930s, private savings in richer countries began to flow less freely into poorer lands. The virtual collapse of international bond markets in the 1930s was one of the factors which led in due course to the establishment of the World Bank (International Bank for Reconstruction and Development) after World War II. Owned by member governments, the Bank lends only to governments or with government guarantees. Meanwhile, the Export-Import Bank, created in 1934, continued as the principal U.S. official lending agency to foreign governments.

The World Bank raises money to lend by selling bonds in the financial markets of the United States and Europe. But, with the notable exception of Canada, bond issues by foreign governments and government agencies in New York and other capital markets have remained relatively small in recent years.

Throughout the postwar years, the United States has been extending economic aid under a succession of programs listed in the table.

U.S. and International Economic Aid Agencies and Programs

(Latest available data, in billions of dollars)

	Date of Establishment	Form of Aid	Authorizations	Disbursements
United States:				
Export-Import Bank	1934	Loans	\$10.7	\$7.4*
International Cooperation Administration and predecessors	1948	Mainly grants	26.1	24.9
Sales of agricultural surpluses against local currencies and emergency food relief (PL 480)	1954	Loans and grants	4.3	3.7
Development Loan Fund	1957	Loans	1.4	0.3
Inter-American Aid for Social Development	1960	Loans and grants	0.5	—
International:				
International Bank for Reconstruction and Development	1944	Loans	5.3	3.9†
International Finance Corporation	1956	Loans	‡	‡
International Development Association	1960	Loans	—	—
United Nations Technical Assistance	1949	Grants	0.2	0.2
United Nations Special Fund	1959	Grants	‡	‡
Regional:				
Inter-American Development Bank	1960	Loans	—	—
European Investment Bank	1958	Loans	0.1	‡
Overseas Development Fund	1958	Grants	0.1	‡
Colombo Plan	1950	—	—	—

* Of which, \$4.0 billion repaid. † Of which, \$0.7 billion repaid. ‡ Less than \$50 million. § European Common Market.

The latest addition is the Inter-American program for social development for which Congress recently authorized, "as a first step," \$500 million.* This program, financed by the United States, is to be administered "primarily" by the Inter-American Development Bank, which is to begin operations later this year. Such aid is to be matched by "measures of self-help."

The United Kingdom, France, the Netherlands, and certain other countries also have government lending agencies and programs to provide aid. Altogether, some twenty-five agencies or programs, including those covered in the table, operate in the field today.

"Soft" Loans

Last week, the International Development Association was established as an affiliate of the World Bank. The new body is to grant loans

*An additional \$100 million was appropriated for rehabilitation of areas of Chile devastated by earthquakes earlier this year.

at low interest rates, repayable in whole or in part in the borrower's own currency.*

The trend is to get away from grants — which are apt to be objectionable to taxpayers — and from hard currency loans like those of the Export-Import Bank or the World Bank. Furthermore, the newer agencies are empowered to extend loans with longer maturities and at cheaper rates than are available from the older ones.

These new kinds of loans are thus designed for borrowers who want and need dollars or other hard currencies but do not have the visible ability to repay in the same coin. They are akin to grants. A point has been made that, while the newer agencies can make soft loans, they need not be soft lenders; and that soft loans are preferable to outright grants because loan procedures exert a discipline on lender and borrower alike to ensure that a project so financed be soundly conceived. This can hold true if a country also disciplines itself in its general fiscal and monetary policies and thus preserves value for its currency in terms of local prices.

There is a natural tendency for borrowers to seek the least onerous terms. It is easier to meet the test of repayment in "local currency" than in dollars, pounds, or marks. Obviously, there is danger lest "bad loans drive out good ones."

Coordinating Aid Programs

There are now so many government-sponsored agencies and programs working in the area of international financial aids that it is hard for the citizen to keep up with them all. It is also hard for aid applicants to know just where to go. Besides, there is a good deal of overlapping, though each new program seemingly has had special circumstances to justify its coming into existence.

To eliminate overlapping, waste, and maladministration, particular grants and loans should be related to the recipient country's own efforts, and activities and contributions of U.S. agencies should be related to those of international institutions and others. Indeed, U.S. and other agencies have recently endeavored to coordinate aid to Spain, Turkey, India, and Pakistan. A Development Assistance Group has been formed among the principal capital-exporting countries to discuss informally various aspects of cooperation in this field. With such a multiplicity of pipelines for channeling aid, the effort can be weakened by overorganization.

The problem of coordination is not confined to aid programs within each recipient country.

*For a discussion of the International Development Association, see the November 1959 issue of this *Letter*, page 181.

There is also the problem of coordinating the whole effort of economically more-advanced nations to assist the less-developed lands.

Throughout recent years, economic aid has been increasing, with the relative contribution of the United States and the other industrialized nations remaining fairly constant. In 1959, government grants and loans by the industrialized countries of the Free World to the less-developed nations were estimated at \$4 billion, of which the United States supplied about two thirds, and France and the United Kingdom most of the remainder.

Economic Assistance to Less-Developed Nations by Certain Industrialized Free-World Countries*

(In millions of dollars)

Country	Annual Average 1954-56	1957	1958	1959	Total 1954-59
Australia	\$ 23.7	\$ 34.3	\$ 41.5	\$ 34.7	\$ 181.6
Belgium	4.0	8.0	12.0	22.2	54.2
Canada	21.4	23.2	60.5	67.4	215.3
Denmark	—	—	0.2	0.5	0.7
France	481.4	857.1	754.6†	770.0	3,825.9
Germany‡	3.0	33.5	107.1	124.9	274.5
Italy‡	5.5	7.6	10.2	38.6	72.9
Japan‡	11.4	3.0	3.0	13.0	53.2
Netherlands	19.5	24.7	22.9	26.9	133.0
New Zealand	3.3	5.8	3.0	4.6	23.3
Norway	1.0	0.9	1.5	0.7	6.1
Sweden	0.7	0.3	0.8	1.1	4.3
Switzerland	0.1	0.1	0.1	0.1	0.6
United Kingdom	161.5	155.9	177.2	241.1	1,058.7
	736.5	1,154.4	1,194.6	1,345.8	5,904.3
United States	1,554.6	2,417.0	2,250.7	2,694.0	12,025.5
Grand Total‡	\$2,291.1	\$3,571.4	\$3,445.3	\$4,039.8	\$17,929.8

*Amounts disbursed (grants and loans) during fiscal years of countries concerned.

†The apparent drop in French aid expenditures is largely accounted for by devaluations of the franc at the end of 1957 and 1958.

‡Not including reparations payments to less-developed countries (Germany about \$428 million, Japan \$204 million, Italy \$181 million through 1959).

Source: Department of State, *Bulletin*, August 22, 1960.

There is no accurate yardstick for comparing the degree of aid effort by various countries. However, as the table shows, there are countries economically and financially strong enough to shoulder a larger part of the aid burden than they have until now. German leaders have recognized publicly the need to assume a greater share of the over-all effort.

The International Development Association represents the most notable effort made so far to bring Western Europe and Japan into aid programs hitherto financed mainly by the United States. Of the \$1 billion capital, the United States is scheduled to pay \$320 million while sixteen other developed nations are to provide \$433 million, entirely in gold or convertible currencies. The other developed countries will, therefore, provide a larger share of IDA's convertible currency resources than the United States.

Russia's Aid "Competition"

Russia has also engaged, since 1954, in supplying aid to less-developed nations. Including modest amounts provided by Russia's European satellites and Red China, economic aid by the Soviet bloc to other nations had reached the equivalent of \$3 billion by April 1960, according to data published by our State Department. In 1959, such aid reportedly totaled \$1 billion—by far the largest amount in any single year.

These are sizable figures, but they must be seen in perspective. In the past three years, as the table shows, the United States alone has extended economic aid at a rate of \$2.5 billion a year, and the other industrialized Free World countries \$1.2 billion. In addition, the World Bank has lent close to \$700 million annually. Finally, private capital outflows from the United States, Canada, Europe, and Japan to less-developed countries must also be taken into account; these have been estimated for recent years at \$2 billion annually. Thus, the total runs beyond \$6 billion a year.

On paper, the terms of Soviet loans are generous, with nominal interest rates of 2 or 2½ per cent. In reality, however, they may be onerous, as many recipients have learned by comparing Russian prices, qualities, and delivery conditions with those of the West. A closer acquaintance with Russian barter dealings and state trading will make it easier to appraise realistically the "advantages" gained from Russian aid.

As time passes and the novelty of Russian aid wears off, the recipients will also realize that greater reliance on Soviet aid dangerously increases their economic dependence on Russia. In fact, these and other deficiencies and shortcomings are becoming all too apparent.

The Neglected Partner

Government grants and loans as well as credits by the World Bank and, soon, by the Inter-American Development Bank and the International Development Association aim at expanding basic economic facilities in such fields as transportation, communications, irrigation, and power. Formerly, underdeveloped nations floated government bonds to finance such projects; but the provision of capital for public works now tends to be regarded as falling within the province of official lending.

Private investment from industrial nations has not been fully enlisted in the task of developing others. To be sure, there has been, over the past decade, a remarkable revival of private long-term investment from the United States and Western Europe. But it has gone, for the most

part, to rapidly expanding countries with a substantial industrial sector, such as Canada, Australia, and Mexico. Private capital has also flowed in sizable amounts to finance the development of important natural resources like oil or metals. Little of it has gone into manufacturing and processing industries or into public utilities.

Private capital cannot be driven by compulsion. It must be attracted. Attracting American and European investment funds to less-developed countries is not an easy matter in view of the competing demands for capital in the more-developed countries themselves.

Yet, the available private capital is potentially many times as great as the amount that can be supplied from government coffers. Investors, understandably, tend to shun countries where they encounter currency disorders, exchange controls, confiscatory taxation, expropriation, company law discrimination, and nationalistic restrictions on management. But when a country offers reasonable assurances of financial stability, respect for contracts, and equality of treatment with domestic capital, foreign capital responds favorably.*

The developing nations can secure much-needed capital for development primarily in one of two ways: they can create a favorable investment climate and thus attract capital from abroad, or, alternatively, they can forego capital imports but they must then step up their own capital formation even at the cost of depressing already-low living standards. The first course requires a strengthening of the bonds between the more-developed and the less-developed nations—above all, free trading and payments and the rule of law. The second course entails immense material and spiritual sacrifices such as those now enforced in Communist China.

One thing is certain, however. Less-developed countries cannot fail to re-establish the conditions needed to attract foreign private capital and, at the same time, claim more government grants and loans to make up for the lack of private foreign investment. People in the more-developed nations will be most reluctant, in the long run, to provide through taxes funds that they do not wish to entrust to other nations of their own free will.

*See "Economic Stabilization in Latin America" in the August 1960 issue of this *Letter*.

The article "Fiscal Policy Reviewed" in the September issue of this *Letter* discussed a speech made by Professor Arthur F. Burns at Los Angeles last spring. The speech was actually given at the School of Business Administration of the University of Southern California rather than at the University of California as reported in the article.



PHOTOGRAPHED IN VICTORIA CRAFTS MARKET, KINGSTON, JAMAICA

Market Signals

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